In the Supreme Court of the United States

OCTOBER TERM, 1974

No. 73-1733

GEORGE T. KIMBELL AND RUTH A. KIMBELL, PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

The sole question raised by the petition is whether a payment made by petitioner[1] in settlement of a threatened lawsuit was deductible as a capital loss, as the decision below held, or as an ordinary and necessary business expense.

The facts giving rise to the payment in question are as follows: Since 1928, petitioner has been engaged in producing and selling oil and gas. He was not in the business of buying and selling oil and gas leases but only in the business of acquiring investments in working interests in leases for the development of oil and gas.

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[1]References to petitioner are to George Kimbell. His wife, Ruth A. Kimbell, is a party solely because she filed a joint income tax return with her husband for the year in question.

On March 8, 1961, the Elba Corporation bought for approximately $840,000 two oil and gas leases in Gregg County, Texas, in which petitioner owned a working interest. Petitioner received $216,861 for his interest, with respect to which he reported a long term capital gain of $193,532. Elba Corporation and its owner, W. O. Davis, financed the purchase by a loan from the Texas Bank and Trust Company of Dallas, Texas, and the bank obtained a security interest in the oil production from the leases as collateral (Pet. App. B, A8-A9).

In 1962, production was halted because it was discovered that the wells on the two leases were illegally slanted. Elba Corporation and Davis defaulted on their loan and the bank immediately asserted a claim and threatened a lawsuit against petitioner for $1,000,000 on the theory that petitioner knew the wells were producing illegally when the leases were sold and that he knew the bank was financing the purchase of the leases. After extended negotiations, petitioner paid $49,500 to the bank on March 30, 1967, in settlement of all claims it had asserted against him (Pet. App. B, A9).

Petitioner deducted the $49,500 settlement payment on his 1967 income tax return as an ordinary and necessary business expense. On audit, the Commissioner disallowed the claimed deduction on the ground that it was a capital loss, subject to the limitations on deductibility provided by Section 1211(b) of the Code.[2] The district court rejected petitioner's claimed refund and the court of appeals affirmed (Pet. App. B, A8-A12; Pet. App. A, A1-A7).

1. The decision below correctly concluded that the transaction that gave rise to the payment at issue was a capital transaction so that petitioner's payment was there-

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[2]Pursuant to Section 1211(b) of the Code, capital losses are only deductible to the extent of capital gains, plus the smaller of the taxpayer's ordinary income or $1,000.

fore capital in nature and deductible only as a capital loss. As this Court has held, the origin and nature of the transaction with respect to which an expenditure is made is the controlling test for determining the tax treatment of a particular payment. *United States* v. *Gilmore,* 372 U.S. 39, 49; *Woodward* v. *Commissioner,* 397 U.S. 572; *United States* v. *Hilton Hotels,* 397 U.S. 580; see also *Anchor Coupling Co.* v. *United States,* 427 F. 2d 429 (C.A. 7). In *Arrowsmith* v. *Commissioner,* 344 U.S. 6, a case involving facts closely analogous to those here, the Court upheld the government's contention that a payment by the shareholders of a judgment against their liquidated corporation and one of the shareholders was deductible only as a capital loss and not as an ordinary business loss. Because the receipt of the liquidation proceeds by the shareholders in *Arrowsmith* was a capital transaction taxable as capital gains under Section 331 of the Code, the disbursement by the shareholders of a portion of those proceeds in satisfaction of the judgment was deductible only as a capital loss.

Similarly, here the asserted liability and settlement payment to the bank were capital in nature because their origin was in the capital transaction of petitioner's sale of the leases which he reported as a sale of a capital asset. The bank's subsequent claim against petitioner was based upon his alleged fraud in that sale. In making the settlement payment, petitioner repaid or reduced his previously reported capital gain. Thus, the settlement payment can only be deductible as a capital loss. Indeed, the allowance of an ordinary loss deduction for the settlement payment and consequent offset against income taxable at the higher rate applicable to ordinary

income would constitute a windfall since the proceeds of the sale of the lease were taxable at the preferential capital gains rate. Cf. *United States* v. *Skelly Oil Co.*, 394 U.S. 678.[3]

2. Petitioner errs in claiming (Pet. 6-7) that the decision below would conflict with *Cummings* v. *Commissioner*, 60 T.C. 91, pending on appeal to the Second Circuit, in the event the Second Circuit should affirm the decision of the Tax Court. There, the Tax Court held that the payment by a corporate officer of insider profits to his corporation, as required by the Securities Exchange Act, is deductible as a business expense. As the court of appeals correctly noted (Pet. App. A, A5) however, the rationale of the Tax Court in the insider profit cases is that the insider's obligation to recompense the corporation arose from the Securities Exchange Act and not from the original stock transaction. The insider profit cases accordingly offer no useful parallel to the question of the deductibility of petitioner's settlement payment. Thus, even if the Second Circuit were to affirm the Tax Court's decision in

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[3]Petitioner's claim (Pet. 6) that the settlement payment was deductible as an ordinary and necessary business expense because it was made to protect his business reputation is contrary to this Court's decisions in *Gilmore*, *Woodward*, and *Hilton Hotels*. Those holdings make clear that it is not the consequences of a payment or its purpose that determine its deductibility but the nature and origin of the transaction giving rise to the payment.

Cummings,[4] there would be no conflict of decisions which would warrant the granting of the petition in this case.

For the reasons stated, it is respectfully submitted that the petition for a writ of certiorari should be denied.

ROBERT H. BORK,
Solicitor General.

SEPTEMBER 1974.

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[4]Both the Sixth and Seventh Circuits have held, contrary to the approach of the Tax Court in *Cummings,* that payments of insider profits by corporate officers under the Securities Exchange Act are deductible only as capital losses. *Mitchell* v. *Commissioner,* 428 F. 2d 259 (C.A. 6); *Anderson* v. *Commissioner,* 480 F. 2d 1304 (C.A 7).